Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Scott	Analyst:	Norm Catelli	Bill Number:	SB 1660
Related Bills:	See Legislative History	Telephone:	845-5117	Amended Date:	April 3, 2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Solar Energy System Definition/Eliminate Sunset Date/*Res Judicata* Application/Joint Strike Fighter Reference/Conform to Federal Law to Exempt Tax Information/Repeal Expired OID Provisions

SUMMARY

Provisions of this bill would:

- add definitions to the Solar Energy System Credit,
- eliminate the sunset date for the court-ordered debt (COD) collection program, and
- clarify application of the *Res Judicata* doctrine to final federal determinations.

This bill also contains provisions, sponsored by the Franchise Tax Board (FTB), to:

- correct an erroneous reference in the Joint Strike Fighter (JSF) Credit,
- assure that the Revenue and Taxation Code (R&TC) is the only means used to dispute a tax liability, and
- repeal obsolete language with respect to original issue discount (OID) treatment.

The provisions of this bill will be discussed separately.

This is the department's first analysis of this bill.

Solar Energy System Credit

PURPOSE OF THE PROVISION

According to the author’s office, the purpose of this provision is to clarify that the current Solar Energy System Credit is also applicable to wind energy systems and includes a definition of “wind energy systems.”

EFFECTIVE/OPERATIVE DATE

This provision would be effective and operative January 1, 2003.

POSITION

Pending.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Gerald H. Goldberg	4/17/02
____ N	____ OUA	__X__ PENDING		

ANALYSIS

FEDERAL/STATE LAW

SB 17XX (Brulte, Stats. 2001, Ch. 12) added a new solar energy credit. This bill allows a credit for the purchase and installation of a solar energy system, defined as either a photovoltaic or wind-driven system, installed on property in the state. The credit is equal to the lesser of:

- 15% of the cost paid or incurred by the taxpayer for taxable years beginning on or after January 1, 2002, and before January 1, 2004, and 7.5% for taxable years beginning on or after January 1, 2004, and before January 1, 2006, or

- the “applicable dollar amount” which means $4.50 per rated watt of the solar energy system.

THIS PROVISION

This provision:

- inserts the phrase “or wind” in numerous phrases referencing “solar energy system,”
- includes a definition of a “wind energy system,” and
- requires certification by the State Energy Resources Conservation and Development Commission.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department’s programs and operations.

LEGISLATIVE HISTORY

SB 17XX (Brulte, Stats. 2001, Ch. 12) added the Solar Energy System Credit to the R&TC.

OTHER STATES' INFORMATION

Illinois, Michigan, Minnesota, and *New York* laws do not provide a credit for wind energy comparable to the credit allowed by this bill. Massachusetts currently has a solar and wind energy credit that is equal to %15 of the net expenditures of $1,000, whichever is less.

The laws of these state were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

This provision would not significantly impact the department’s costs.

ECONOMIC IMPACT

Since the original revenue loss estimates for the Solar Energy System Credit were based on the assumption that wind energy systems would be included in the definition of “solar energy system,” the current law estimates include wind energy systems. Therefore, this provision would have no revenue impact.

Court Ordered Debt (COD) Collection Program

PURPOSE OF THE PROVISION

According to the author's staff, the purpose of this provision is to allow FTB continuing authority to collect COD.

EFFECTIVE/OPERATIVE DATE

This provision would be effective and operative January 1, 2003.

POSITION

Pending.

ANALYSIS

STATE LAW

State law authorizes FTB to administer several non-tax programs, one of which is the COD collection program.

FTB's COD program collects fines, state or local penalties, forfeitures, restitution fines, restitution orders, or any other amounts imposed by a superior or municipal court of the State of California. Only those amounts equal to or exceeding $250 in the aggregate is referred to FTB for collection. The amounts that are referred include those imposed for violating the Vehicle Code, except those relating to parking or registration or offenses by pedestrians or bicyclists. FTB is authorized to collect the referred amounts as though they are delinquent personal income taxes.

Under current law, FTB's COD collection program authorization would sunset January 1, 2003.

THIS PROVISION

This provision would remove the sunset date for FTB's COD collection program, which would give FTB permanent statutory authority to collect these debts.

IMPLEMENTATION CONSIDERATIONS

Since this provision would extend an existing collection program, implementation of this provision would not significantly impact the department's programs and operations.

LEGISLATIVE HISTORY

AB 2388 (La Suer, 2001/2002) would extend the sunset date of the COD program for three years. This bill was introduced February 21, 2002, and has not been scheduled for hearing.

SB 1310 (Vasconcellos, Stats. 2000, Ch. 940) extended for one year, until January 1, 2003, the sunset of the pilot COD collection program administered by FTB and required FTB to address in its report, which was due to the Legislature on or before April 1, 2001, the feasibility and advisability of expanding the COD collection program to accept referrals from all 58 counties.

SB 1106 (Senate Revenue and Taxation Committee, Stats. 1997, Ch. 604) extended the COD pilot program by three years to January 1, 2002, increased the program's cost cap to 15%, and clarified types of debt that FTB could collect.

AB 3343 (Hannigan, Stats. 1994, Ch. 1242) authorized counties or the state to refer to FTB for collection CODs under a pilot program beginning January 1, 1995, and expiring January 1, 1999.

PROGRAM BACKGROUND

FTB's COD program began January 1, 1995. Client participation in the program is voluntary and the department currently has 22 clients (out of approximately 80 total clients available in California) and the California Victim Compensation and Government Claims Board (formerly Board of Control) participating in the program. All money collected is deposited into the Court Collection Fund, which was created for the COD program. The balance of the account (minus FTB's administrative fee of up to 15%) is transferred to the courts, counties, or state agency to which the debt is owed.

As required under current law, FTB submitted a report to the Legislature in early 2001 that outlined the results of the COD collection program. As of February 2002, the department has received just over 737,000 case referrals, resulting in approximately $70.8 million in collections. According to the report submitted in 2001, several additional counties have expressed an interest in joining the COD program if the sunset date were removed, which would further increase collection potential.

OTHER STATES' INFORMATION

Since this provision extends the sunset date of an already existing California collection program, a review of the court-ordered debt collection practices of other states does not offer a meaningful comparison.

FISCAL IMPACT

This provision would not significantly impact the department's costs. Under current law, the department's cost to administer this program is reimbursed through the amounts the department collects. The department receives up to 15% of any amount collected.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Collection Impact of SB1660 For Collections After 1/1/2003 Fiscal Year Impact (In Millions $)		
2002-03	2003-04	2004-05
$10	$30	$35

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Revenue Discussion

The collection impact of this proposal will depend on the number of court-ordered debt cases referred to FTB for collection and the average amount of the collections for each case.

This estimate is based on the results of FTB's existing court-ordered debt collection program. The timing of collections is integral to this estimate because (1) accounts that are referred in the later part of a fiscal year typically would not result in collections until the next fiscal year, and (2) during a given fiscal year, in addition to single payments attributable to new collection actions taken on new referrals, multiple, ongoing payments would be coming in as a result of wage levies issued or payment arrangements made on older referrals from prior fiscal years.

Res Judicata Doctrine & Final Federal Determinations

This provision was amended into this bill on April 3, 2002. Due to the complexity of the subject matter, an analysis has not been completed. This analysis will be amended as soon as a complete analysis is completed.

Joint Strike Fighter Credit

PURPOSE OF THE PROVISION

The purpose of this provision is to correct an erroneous reference in existing law that may confuse taxpayers and result in the understatement of their JSF Credit.

EFFECTIVE/OPERATIVE DATE

This provision would be effective and operative on January 1, 2003.

POSITION

On March 6, 2002, the Franchise Tax Board voted 2-0 to sponsor this provision.

ANALYSIS

FEDERAL/STATE LAW

There is not a comparable federal credit specifically for the JSF program.

Under current state law, qualified taxpayers are allowed a wage credit and a property credit for the JSF program. "Qualified taxpayers" are defined to include those taxpayers under an initial contract or subcontract to manufacture property (described below under "Program Background") for ultimate use in a JSF. The credits are available for taxable years beginning on or after January 1, 2001, and before January 1, 2006. Any excess credit can be carried forward for up to eight years.

The credits are allowed only if the bid that the JSF contract or subcontract is based upon is reduced by the credit amount. The taxpayer is required to provide, at the request of the Franchise Tax Board, all references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a JSF contract or subcontract.

- The *wage credit* is generally equal to a specified percentage (50% for 2001, 40% for 2002, 30% for 2003, 20% for 2004, and 10% for 2005) of employee wages that are direct costs allocable to property manufactured in this state for ultimate use in a JSF, with certain limitations.

- The *property credit* is generally equal to 10% of the cost of qualified property used by a taxpayer primarily in qualified activities to manufacture a product for ultimate use in a JSF, with certain exceptions. The property credit is to be recaptured if within one year of being placed in service the property is sold, moved out of state, or used for purposes other than manufacturing a product for ultimate use in a JSF.

  "Qualified property" means tangible personal property and capitalized labor costs that are treated as direct costs allocable to that property. The qualified property is required to be used by a taxpayer primarily in activities to manufacture a product for ultimate use in a JSF.

  "Capitalized labor costs" are those labor costs that can be included/added to the value of the property to determine its cost. For example, if a widget requires two hours of labor to produce and the cost of the labor is $10, then the labor cost is directly related to the widget's value and may be included in the cost of the widget.

THIS PROVISION

This provision would clarify that capitalized labor costs that are direct costs are includible in the calculation of qualified property.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs and operations.

LEGISLATIVE HISTORY

AB 2797 (Machado, Stats. 1998, Ch. 322) added the Joint Strike Fighter Credit to the Revenue and Taxation Code (R&TC).

PROGRAM BACKGROUND

The JSF program is the Department of Defense's "affordable next generation strike aircraft weapon systems" for the Navy, Air Force, Marines, United Kingdom Royal Navy, and other U.S. allies. There are five phases to the JSF program: exploration, development, demonstration, engineering and manufacturing development (EMD), and production.

The exploration, development, and demonstration phases have been completed.

The EMD phase is basically the manufacture of prototype aircraft or related products (property) that will be used for finally approved aircraft in the JSF program. Upon completion of the demonstration phase, the initial contract for the EMD phase was awarded to Lockheed Martin Corporation in late October of 2001. The EMD phase is estimated to take six years to complete, beginning in 2002 or later. The JSF tax credits will be claimed during this phase.

The production phase is planned thereafter. The initial contract and subcontract work for the production phase is expected to be performed outside California. Currently, no contracts have been awarded for the production phase.

OTHER STATES' INFORMATION

This bill would correct an erroneous statutory reference in the California Corporation Tax Law. Accordingly, a comparison with the laws of other states is irrelevant.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Since the original revenue loss estimates for the JSF Credit were based on the assumption that capitalized labor costs would be included in qualified costs, the current law estimates already include the effects of the cross-referencing correction. Therefore, this provision would have no revenue impact.

<u>IPA Record Amendment Procedures and Remedies</u>

PURPOSE OF THE PROVISION

The purpose of this legislation is to conform to federal procedures, as modified, affirming that the proper method of altering or disputing a taxpayer's tax liability is under the statutes provided in the R&TC.

EFFECTIVE/OPERATIVE DATE

This provision would be effective and operative January 1, 2003, and would apply on or after that date.

POSITION

On March 6, 2002, the Franchise Tax Board voted 2-0 to sponsor this provision.

ANALYSIS

FEDERAL/STATE LAW

The Federal Privacy Act (FPA) provides individuals specific rights and protection in regard to their personal records. Among other provisions, the FPA requires agencies to comply with an individual's request for personal records and establishes procedures for an individual to request amendment of those records. The FPA also creates a cause of action if the agency fails to comply with the FPA. Current state law provides for the Information Practices Act of 1977 (IPA). The IPA is closely modeled after the FPA and provides an individual the same rights to request and amend records, and cause of action as that discussed above.

The IRC specifically excludes tax information and matters related to tax liability from the FPA record amendment process. The IRC also excludes the IRS from any cause of action for the failure to comply with request for documents under the FPA.

Federal and state laws allow a taxpayer to alter his or her tax liability for a taxable year by allowing him or her to file an amended tax return under either the IRC for federal taxes and under the R&TC for California franchise and income taxes. An amended return may result in the taxpayer having a reduced tax liability, in which case, the amended return is considered a claim for refund.
Federal and state laws also provide the Internal Revenue Service and FTB authority to issue proposed income tax assessments. A taxpayer may receive a proposed income tax assessment for a particular year. This assessment may state that the taxpayer did not file a return or the return understated the tax liability and additional tax is owed. In addition to other statutory procedures to dispute the assessment, namely protest and appeal, a taxpayer may pay the assessment and file a claim for refund refuting the adjustments that resulted in additional tax.

Unlike federal tax law, the R&TC provides no express exclusion from the IPA's amendment process or causes of action so that it is clear that the procedures within the R&TC are the sole method to dispute a tax liability.

THIS PROVISION

This provision would prevent a person from using the IPA to:

- request corrections to their income tax accounts,
- appeal the denial of a request to amend a tax record,
- require copies of a statement disagreeing with the denial of a request to amend records be made part of the official record, and
- file a cause of action against FTB for not complying with a taxpayer's request to amend their income tax liability using the IPA amendment process.

This provision would conform California law to the federal law that provides a single process for a taxpayer to dispute or amend their income tax liability, which is through the tax code.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would assure that a taxpayer would be required to use the tax return amendment and dispute resolution processes found in the R&TC for disputing relating to a tax record or tax liability. Implementing this provision would not impact the department's programs and operations.

LEGISLATIVE HISTORY

SB 2051 (Bowen, 2001/2002) has a provision identical to this provision. The bill is awaiting a hearing date.

OTHER STATES' INFORMATION

The laws of *Illinois, Massachusetts, Michigan, Minnesota,* and *New York* were reviewed because of their similarities to California's laws. Each of these states has a specific process or processes for challenging and disputing a taxpayer's income tax liability.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

This provision would not impact the state's income tax revenue.

OID CLEAN-UP

PURPOSE OF THE PROVISION

The purpose of the provision is to eliminate superfluous transition rules regarding OID as a matter of code maintenance.

EFFECTIVE/OPERATIVE DATE

This provision would be effective and operative on January 1, 2003.

POSITION

On March 6, 2002, the Franchise Tax Board voted 2-0 to sponsor this provision.

ANALYSIS

FEDERAL/STATE LAW

The advent and growth of a new financial instrument known as a "zero coupon bond" presented tax-planning opportunities for cash-basis taxpayers. Zero coupon bonds are issued at a discount to their stated face value and redeemed for an amount that includes a principal and an interest component. The difference between the issuance price and the stated redemption price is known as "original issue discount" or OID.

The result of the advent of zero coupon bonds was that cash basis taxpayers were able to defer the tax on the accrued interest income until the bonds were redeemed, or alternatively were able to sell the instrument and include the OID component as part of their reported capital gain.

Congress' desire to end these tax benefits led to the enactment of the Deficit Reduction Act of 1984 (DRA). The DRA added Part V, *Special Rules for Bonds and Other Debt Instruments*, to Subchapter P, *Capital Gains and Losses,* of the IRC, encompassing IRC Sections 1271-1288. This part, and related regulations, provides exhaustive, complex statutory rules for the definition of debt instruments, calculation of amounts of OID to be included in income, and miscellaneous provisions, including the treatment of OID on tax-exempt obligations.

California law generally conforms to the federal treatment of OID.

In conforming to federal treatment in 1987, California developed transition rules for OID obligations issued during 1985 and 1986. These rules required the taxpayer to include all the OID from these obligations in income in the year of sale or maturity. Alternatively, the taxpayer could elect to recognize the OID amounts for 1985 and 1986 ratably over four tax years, 1987-1990, and include in income the federal OID amount for years beginning in 1987.

In conforming to the federal Taxpayer Relief Act of 1997, California developed transition rules related to pooled debt obligations. These rules provided that the difference between federal and state amounts is taken into account ratably over four taxable years, 1998-2001.

THIS PROVISION

This provision would repeal the existing code section that is now obsolete with respect to OID transition rules.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would assist the department's programs and operations by easing the administration of the tax law.

FISCAL IMPACT

No departmental costs are associated with this provision.

ECONOMIC IMPACT

Eliminating statutory language that is no longer necessary because relevant taxable or other periods have already expired would not impact state income tax revenues.

LEGISLATIVE STAFF CONTACT

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